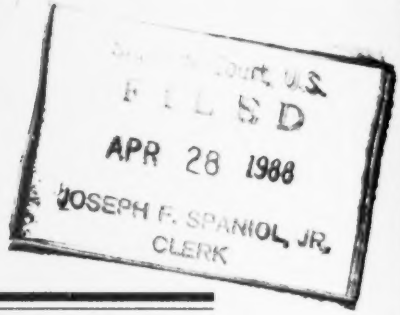
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No. _____

IN THE
Supreme Court of the United States

OCTOBER TERM, 1987

In the Matter Of

READING COMPANY,

Petitioner.

CJI INDUSTRIES, INC.,
formerly known as
Central Jersey Industries, Inc.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT AND APPENDIX

William H. Ewing
(Counsel of Record)
Gary A. Rosen
HANGLEY CONNOLLY EPSTEIN
CHICCO FOXMAN & EWING
1429 Walnut Street, 14th Floor
Philadelphia, PA 19102
(215) 864-7720

Attorneys for Petitioners

STATEMENT PURSUANT TO RULE 28.1

Petitioner Reading Company has the following subsidiaries (except wholly owned subsidiaries) and affiliates: American Lignite Products Company; Ione Energy, Inc.; El Paso Refining Company, Ltd.; Baltimore and Cumberland Valley Railroad Extension Company; North Pennsylvania Railroad Company (liquidating trust); The Philadelphia Belt Line Railroad Company; Ironton Railroad Company; Pennsylvania-Reading Seashore Lines; Parametric Garage Associates; SR Developers; Reading Industrial Center Partners; and 1301 Joint Venture.

QUESTION PRESENTED FOR REVIEW

Whether a court of appeals improperly circumscribes the discretion of a district court, sitting in bankruptcy, when it holds that the district court cannot allow a debtor to assert a prebankruptcy claim as a setoff against a prebankruptcy debt in making distribution under the debtor's reorganization plan.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Reading Company respectfully petitions this Court to issue a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in *In the Matter of Reading Company*, C.A. No. 87-1232, entered on January 29, 1988.

OPINIONS BELOW

The opinion of the district court is reported at 72 Bankr. 293 and is reproduced in the Appendix to this petition as Appendix B (14a-20a).

The opinion of the court of appeals is reported at 838 F.2d 687 and is reproduced in the Appendix to this petition as Appendix A (1a-13a).

JURISDICTION

The court of appeals' judgment was entered on January 29, 1988. This Court has jurisdiction to review the judgment of the court of appeals under 28 U.S.C. § 1254(1) (1982).

STATUTORY PROVISIONS INVOLVED

Sections 2a(2) and 2a(15) of the Bankruptcy Act of 1898, as amended (the "Bankruptcy Act"), formerly codified at 11 U.S.C. § 11 (1976), provide:[1]

> The courts of the United States hereinbefore defined as courts of bankruptcy are hereby invested, within their respective territorial limits as now established or as they may hereafter be changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—
>
> (2) Allow claims, disallow claims, reconsider allowed or disallowed claims, and allow or disallow them against bankrupt estates;

1. Section 2a(2) of the Bankruptcy Act is substantively recodified and carried forward by § 502 of the Bankruptcy Code of 1978 (the "Bankruptcy Code"), 11 U.S.C. § 502 (1982), and § 2a(15) of the Bankruptcy Act is substantively recodified and carried forward by § 105 of the Bankruptcy Code, 11 U.S.C. § 105 (1982).

> (15) Make such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this Act: *Provided, however*, that an injunction to restrain a court may be issued by the judge only;

Section 70(c) of the Bankruptcy Act, formerly codified at 11 U.S.C. § 110(c) (1976), provides in pertinent part:[2]

> The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee.

Section 68(a) of the Bankruptcy Act, formerly codified at 11 U.S.C. § 108(a) (1976), provides:[3]

> In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

Section 14(f)(2) of the Bankruptcy Act, formerly codified at 11 U.S.C. § 32(f)(2) (1976), provides:[4]

> An order of discharge shall—
>
> enjoin all creditors whose debts are discharged from thereafter instituting or continuing any action or employing any process to collect such debts as personal liabilities of the bankrupt.

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2. Section 70(c) of the Bankruptcy Act is substantively recodified and carried forward in pertinent part by § 558 of the Bankruptcy Code, 11 U.S.C.A. § 558 (Supp. 1987).

3. Section 68(a) of the Bankruptcy Act is substantively recodified and carried forward by § 553 of the Bankruptcy Code, 11 U.S.C. § 553 (1982).

4. Section 14(f)(2) of the Bankruptcy Act is substantively recodified and carried forward by § 524 of the Bankruptcy Code, 11 U.S.C. § 524 (1982).

Section 77(*l*) of the Bankruptcy Act, formerly codified at 11 U.S.C. § 205(*l*) (1976), provides:

> In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed.

STATEMENT OF THE CASE

Petitioner Reading Company ("Reading") formerly operated a railroad under the same name. On November 23, 1971, Reading instituted this reorganization proceeding in the United States District Court for the Eastern District of Pennsylvania pursuant to Section 77 of the Bankruptcy Act. The district court had jurisdiction pursuant to Section 77 and 28 U.S.C. § 1331 (1982). The reorganized company emerged from bankruptcy on January 1, 1981.

Respondent CJI Industries, Inc. ("CJI") formerly operated a railroad under the name The Central Railroad Company of New Jersey ("Central Railroad"). Central Railroad commenced Section 77 proceedings in the District of New Jersey on March 23, 1967 and CJI, the reorganized company, emerged therefrom on September 13, 1979.

Reading and Central Railroad each had prebankruptcy claims against the other. After some wrangling, CJI ultimately acknowledged Reading's general prebankruptcy unsecured claim of $466,428.35 against Central Railroad, and Central Railroad was allowed a general prebankruptcy unsecured claim against Reading of $497,945.52. Orders entered in each of the bankruptcies stayed creditors from setting off their obligations to the debtors during reorganization proceedings. Reading's reorganization plan, which was approved May 21, 1980, provided that claims such as Central Railroad's would be paid *in full* by Unsecured Cred-

itor Notes, recourse obligations payable no later than April 1, 1988 with interest of 8% from January 1, 1981. Under Central Railroad's reorganization plan, creditors of Reading's class were to receive nonrecourse "Series I Contingent Notes," payment of which was contingent on the outcome of Central Railroad's valuation proceedings under the Regional Rail Reorganization Act. Reading and CJI were each discharged of all obligations other than those created by their respective reorganization plans and were each vested with all property (including receivables) of the respective debtors free and clear of any encumbrances.

The order approving consummation of the Central Railroad reorganization plan ("Central Railroad Order 965") contained the following provision:

> [A]ny holder of securities, claimant or creditor against whom the Debtor has a prebankruptcy claim which has not, contrary to prior orders of this Court prohibiting setoffs, been satisfied or against whom the Trustee has an unpaid post-bankruptcy claim which has been liquidated shall pay such claims in cash and shall be entitled to receive a distribution of securities or cash pursuant to the Plan only at such time as such claim of the Debtor or Trustee is fully satisfied by payment of cash to the Reorganized Company or by deduction of the amount of such claim from any cash which such holder of securities, claimant or creditor would otherwise be entitled to receive pursuant to the Plan.

The order approving consummation of Reading's reorganization plan ("Reading Order 2004") contained virtually identical language. This language required each railroad to collect its counterclaims in full, by cash or setoff, before paying any creditor under its plan.

In direct contravention of the provisions of Central Railroad Order 965, CJI tendered Series I notes to Reading even though Reading had not paid Central Railroad's prebankruptcy claim against Reading. Reading refused CJI's tender of the Series I notes, which subsequently proved to be worthless.

The instant controversy arises from the petition of CJI, as successor to Central Railroad, to compel issuance of Unsecured Creditor Notes in the full amount of its allowed claim. Reading has tendered Unsecured Creditor Notes for $31,517.17 only, that being the balance due on Central Railroad's $497,945.25 claim after setoff of its acknowledged $466,428.35 debt to Reading. The district court denied CJI's petition and allowed Reading's setoff, noting the essential inequity that would result if Reading were forced to pay CJI in full, while receiving absolutely nothing of value on its claim against Central Railroad.

The court of appeals held that the district court's allowance of the setoff constituted an abuse of discretion. According to the court of appeals, such setoff constituted a form of "fortuitous" discrimination against CJI with respect to other creditors of the same class that did not owe Reading any money. The court of appeals was unable to distinguish *Baker v. Gold Seal Liquors, Inc.*, 417 U.S. 467 (1974), where this Court ruled that a district court could not allow a *creditor*, who also owes money to a debtor operating a railroad, to assert a setoff to avoid paying the sums it owes during the course of the railroad's reorganization proceeding, because such a setoff would deprive the railroad of needed operating capital and permit the creditor to obtain a preference over other creditors against whom the debtor did not have claims. In accordance with its belief that it was bound by *Baker*, the court of appeals reversed the district court's considered, discretionary ruling.

REASONS FOR GRANTING THE PETITION

This petition seeks definitive resolution of a common dilemma in the law of debtors and creditors: When mutually indebted parties (or two parties having any contractual relation) have each separately sought the protection of the bankruptcy laws, how are their accounts, and conflicting orders of their respective bankruptcy courts, to be recon-

ciled? The district court's solution in this case, setting off Reading's smaller claim against CJI's larger claim, permitted each party to realize the full value of its claim. Remarkably, however, the court of appeals concluded that the district court abused its equitable discretion and held that this Court's precedents allow CJI a double recovery, *i.e.*, complete discharge of Central Railroad's debt for no value *and* 100 cents on the dollar for its own claim against Reading. The decision of the court of appeals merits review by this Court to address this important issue in the administration of the bankruptcy laws and to make clear that a bankruptcy court's discretion is not so constrained as to require such an inequitable result.

A. A District Court, Sitting In Bankruptcy, Has Broad Discretion To Allow The Debtor To Set Off Prebankruptcy Claims Against Prebankruptcy Debts In Making Distribution Under The Debtor's Reorganization Plan.

Bankruptcy courts are courts of equity and their proceedings are inherently proceedings in equity. *United States National Bank v. Chase National Bank*, 331 U.S. 28, 36 (1947). Bankruptcy courts are guided by equitable doctrines and principles except insofar as they are inconsistent with the bankruptcy acts of Congress. *Bank of Marin v. England*, 385 U.S. 99, 103 (1966); *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 455 (1940). As this Court has held, "[t]he equity powers of the bankruptcy court play an important part in the administration of bankrupt estates in countless situations in which the judge is required to deal with particular, individualized problems." *Butner v. United States*, 440 U.S. 48, 55-56 (1979). Where the bankruptcy statutes are silent with regard to a particular problem, general rules of equity jurisprudence fill the interstices. *See Lowden v. Northwestern National Bank & Trust Co.*, 298 U.S. 160, 164 (1936) (Cardozo, J.). *See also* Bankruptcy Act, § 2a(15).

The equitable powers of the bankruptcy court are nowhere broader than in the allowance or disallowance of claims against the estate. *See Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156 (1946); *Inter-State National Bank of Kansas City v. Luther*, 221 F.2d 382, 389 (10th Cir. 1955) ("[T]he bankruptcy court is empowered to attach appropriate conditions to the allowance of a claim, including the power to require the claimant to do equity before receiving equity in the bankruptcy proceedings."), *cert. granted*, 350 U.S. 810 (1955), *cert. dismissed*, 350 U.S. 944 (1956). *See also* Bankruptcy Act, § 2a(2).

This interplay between statute and general principles of equity is well-illustrated by the equitable doctrine of setoff.[5] Setoff is "grounded on the absurdity of making A pay B when B owes A." *Studley v. Boylston National Bank*, 229 U.S. 523, 528 (1913). The doctrine, which was unknown at common law, was developed by equity in exercise of "its broad powers to prevent circuity of action, to enforce the maxim that he who seeks equity must himself do equity and, in general, to do equity between the parties where such legal right of setoff as existed was not adequate to accomplish this result and the case fell within the limits of recognized equitable principles." *Savings Bank of New London v. Santaniello*, 130 Conn. 206, 210-11, 33 A.2d 126, 128-29 (1943) (citations omitted). Already well-established at equity, which recognized the "essential unfairness of excluding setoffs against plaintiffs of doubtful financial condition," Comment, *supra* note 5, at 512, the doctrine of setoff was incor-

5. "Setoff" has been defined as "that right which exists between two parties to net their respective debts where each party, as a result of unrelated transactions, owes the other an ascertained amount. In any action brought for the larger debt, only the balance would then be recoverable." Comment, *Setoff In Bankruptcy: Is the Creditor Preferred or Secured?*, 50 U. Colo. L. Rev. 511, 511 (1979).

porated into the United States' first bankruptcy statute, the Bankruptcy Act of 1800, ch. 19, § 42, 2 Stat. 33,[6] and has been carried forward by the bankruptcy reforms of 1841, 1867, 1898 and 1978. This codification of the doctrine of setoff neither contracted nor expanded its scope, but simply placed it "within the control of the bankruptcy court, which exercises its discretion in these cases upon the general principles of equity." *Cumberland Glass Manufacturing Co. v. DeWitt*, 237 U.S. 447, 455 (1915).

The fundamental equities underlying the doctrine of setoff are so powerful that the bankruptcy laws incorporate it despite the fact that, when asserted by a creditor, it results in that creditor, to the extent the setoff cancels its own obligation dollar for dollar, receiving more than other creditors in the same class who obtain only a pro rata distribution. As one leading treatise states:

> Without such enactment, it could be argued that any attempt to offset a mutual debt and claim between the estate and a creditor would amount to a preference . . . and would, therefore, be invalid. The Code, however, has recognized the possible injustice in compelling a creditor to file its claim in full and accepting possible dividends thereon, while at the same time paying in full its indebtedness to the estate.

4 *Collier on Bankruptcy* ¶ 553.02 at 553-9 - 553-10 (15th ed. 1988). *See also Cumberland Glass Manufacturing Co.*, 237 U.S. at 455 ("While the operation of this privilege of set-off has the effect to pay one creditor more than another, it is a provision based upon the generally recognized right of mutual debtors, which has been enacted as part of the bankruptcy act, and when relied upon should be enforced by the court."). Where, on the other hand, the *debtor* asserts a setoff, as in this case, no tension whatever exists between the rules regarding priority of distribution and the equities of setoff,

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6. Interestingly, "[i]t was through bankruptcy proceedings that set-off first obtained a foothold in English law." Loyd, *The Development of Set-Off*, 64 U. Pa. L. Rev. 541, 547 (1916).

as the net claim allowed is all that the creditor is actually owed. *See Carstens v. McLean*, 7 F.2d 322 (9th Cir. 1925); *In re Braniff Airways, Inc.*, 42 Bankr. 443 (Bankr. N.D. Tex. 1984). *See also* Bankruptcy Act, § 70(c).

The district court found no reason in the instant case to depart from the usual rule of equity and bankruptcy that a party should not be forced to pay a claim in full while it has an outstanding counterclaim. Indeed, the district court found that the equities favoring setoff were "especially acute" with respect to claims between two reorganized companies (18a). Thus, each party's creditors had an equal interest in the "fair and equitable" distribution of assets (which included receivables), and each party's reorganization consummation order (Central Railroad Order 965 and Reading Order 2004) *required* payment of any debts owed to the railroad, in cash or by setoff, as a condition precedent to receiving any distribution under the plan (19a). ("In such an impasse, the railroads would have to offset their claims against each other or there would be a stalemate forevermore.").[7] Most important of all, the district court found that it would be grossly inequitable to deny Reading setoff in this case, because setoff was the *only* way Reading could recover *anything* on its claim, since CJI was distributing worthless securities under its reorganization plan, and its discharge precluded Reading from seeking any affirmative relief (18a).

The district court's exercise of its equitable discretion was proper. Generally, courts of appeals are loath to disturb such determinations, recognizing both the scope of the bankruptcy court's discretion and the expertise it acquires in the course of supervising a complex, lengthy proceeding which only comes before the appellate court in a piecemeal fashion. The court of appeals in this case, however, relying

7. As the district court correctly noted, CJI's tender of Series I Contingent Notes to Reading was premature under Central Railroad Order 965, which required that Reading's debt first be paid by cash or setoff (19a). CJI's eagerness to tender these notes in the full amount of Reading's claim is easy to explain — they were worthless.

entirely upon this Court's opinion in *Baker v. Gold Seal Liquors, Inc.*, 417 U.S. 467 (1974), held that the district court abused its discretion. According to the court of appeals, *Baker* permits a debtor in a Section 77 rail reorganization proceeding to set off its prebankruptcy claims against its prebankruptcy debts only in "extraordinary circumstances" that were not present here (6a).

The court of appeals' holding stands *Baker* on its head. In *Baker* the trustees of an operating railroad in reorganization sought to collect prebankruptcy freight charges in order to pay for the continued operation of the railroad. When they brought a lawsuit on the prebankruptcy freight claim in another federal district court, the defendant shipper asserted a setoff for damages to goods in transit, and the court entered a net judgment in favor of the shipper. The court of appeals affirmed. This Court reversed, stating that Section 68 of the Bankruptcy Act, providing for setoff, applied to rail reorganization proceedings only when it was "consistent with the provisions" of Section 77. 417 U.S. at 470-71 n.3.[8] The Court found the setoff by the shipper inconsistent with the provisions of Section 77 in two respects. First, it violated Section 77's concern for providing the railroad with "cash inflow sufficient for operating purposes, at least at survival levels." 417 U.S. at 471. Second, the Court went on to hold that setoff was not consistent with the rule of "fair and equitable" treatment of each class of claimants, as codified in Bankruptcy Act § 77(e)(1), because "it grants a preference to the claim of one creditor over the others by the happenstance that it owes freight charges that the others do not. That is a form of discrimination to which the policy of § 77 is opposed." 417 U.S. at 474.

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8. Under the current Bankruptcy Code, adopted just four years after *Baker*, Congress has made clear that the sections concerning setoff *do* apply to rail reorganizations. 11 U.S.C. §§ 553, 1161 (1982).

The rule of *Baker* has no application to the present case.[9] Neither Reading nor CJI operates a railroad now, so the public need to keep the trains running is irrelevant. Moreover, allowance of setoff *by the debtor* will obviously not reduce cash flow even to the reorganized debtor, and will not result in a *de facto* preference to any creditor. Quite the contrary, it will prevent one creditor, CJI, from gaining, in effect, a windfall double recovery—complete forgiveness of its own debt to Reading (which was discharged in Central Railroad's bankruptcy and for which Reading received no value) *and* complete recovery on its claim. Rather than reaping a benefit by virtue of the fact that it owes Reading money, as the creditor would have in *Baker* if setoff had been allowed, CJI would be placed in the same position as Reading's other unsecured creditors, *i.e.*, receiving 100 cents on the dollar for the actual net amount it is owed by Reading.

The court of appeals' reason for rejecting these profferred distinctions between the present case and *Baker* was a *non sequitur*. It stated:

> To permit Reading to effect a setoff would be to treat CJI less favorably than Reading's other unsecured creditors. Whereas the other creditors would receive unsecured notes likely to be paid in full, CJI's claim would be largely eliminated by Series I notes of indeterminate value. *Baker* specifically disapproved fortuitous discrimination between creditors of the same class . . . . (12a)

It is nothing short of bizarre to suggest that a creditor who also owes the estate a sizable sum of money is being "fortuitously" discriminated against because it does not receive as much as it would have received if it had not owed the estate any money. The simple fact is, there is no discrim-

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9. The majority opinion of Justice Douglas did go on to state that "[a]s a general rule of administration for § 77 Reorganization Courts, the setoff should not be allowed." 417 U.S. at 474. As pointed out in the concurrence of Justices Stewart and Powell and the dissent of Justice Rehnquist, however, this statement was merely a dictum unnecessary to the decision of the case. 417 U.S. at 474-75, 482.

ination at all. Under the district court's ruling, CJI, like all other unsecured creditors of Reading, would receive the full net amount it is owed in the form of Unsecured Creditor Notes to be paid in full with interest.

In sum, *Baker* was concerned with maintaining a railroad debtor's cash flow during reorganization and preventing a creditor from using setoff to obtain an advantage by virtue of the fact that it also owed the debtor money.[10] Thus, *Baker* is wholly inapposite to a situation, such as that presently before the Court, where a *debtor* — having emerged from reorganization and no longer operating a railroad — asserts a setoff to prevent a creditor from getting *more* than the net amount it is owed. The Bankruptcy Court, as a court of equity, must have the discretion to allow such a

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10. Throughout these proceedings, CJI has argued that *Baker* applies because, viewed from the standpoint of *Central Railroad's* reorganization, CJI is a debtor deprived of cash flow and Reading is a creditor receiving a *de facto* preference over other creditors who did not owe Central Railroad money. This argument is without merit. Central Railroad, like Reading, is no longer operating a railroad and therefore the first concern of *Baker*, preserving cash flow, is equally inapplicable to it. Indeed, in *In re CJI Industries, Inc.*, Dkt. No. 88-5172 (3d Cir.), wherein CJI seeks to escape liability for the occupational disease claims of former Central Railroad employees, CJI has recently filed a brief contending that, unlike Reading's, its bankruptcy was effectively a *liquidation* rather than a *reorganization*. *Compare Schweitzer v. Conrail*, 758 F.2d 936 (3d Cir.) (reorganized Reading liable for former railroad employees' occupational disease claims), *cert. denied*, 474 U.S. 864 (1985), *with In re Erie Lackawanna Railway Co.*, 803 F.2d 881 (6th Cir. 1986) (effectively liquidated Erie Lackawanna not liable for former railroad employees' occupational disease claims), *cert. denied sub nom. Conrail v. Erie Lackawanna, Inc.*, 107 S. Ct. 2463 (1987). Moreover, as discussed fully at pages 14-17 below, the fact that Central Railroad also entered bankruptcy does not constrain the equitable discretion of *Reading's* Reorganization Court to protect the Reading estate and its creditors — it is merely one of many factors the district court below properly weighed in reaching its considered judgment. Finally, Central Railroad Order 965 explicitly required setoff, a requirement that CJI blithely ignored in tendering the Series I notes to Reading despite the existence of Reading's unpaid debt to Central Railroad.

setoff, and no countervailing policy of bankruptcy law calls for any different result in this case. This Court should review the judgment below to make clear that courts of appeals should not unduly fetter the discretion of bankruptcy courts to allow setoff in the context of the payment of claims pursuant to a plan of reorganization.

B. A District Court's Discretion To Allow Setoff Of Claims By The Debtor Is Not Precluded By Orders Entered In The *Creditor's* Bankruptcy.

Throughout these proceedings, CJI has asserted orders entered in the Central Railroad bankruptcy as some form of collateral bar to setoff by Reading in this case. According to CJI, confirmation of its reorganization plan constituted a final adjudication that Reading had no claim against Central Railroad for anything except worthless Series I Contingent Notes. Because the court of appeals decided this case entirely on the basis of its misreading of *Baker*, it specifically declined to reach the issue of the binding effect of Central Railroad's bankruptcy orders on the Reading bankruptcy court (6a n.1). That issue was, however, plainly raised below and ruled upon by the district court, which decided the case on stipulated facts. Under these circumstances, remand will serve no purpose and this Court may give plenary consideration to this important issue in the administration of the bankruptcy laws.[11] *See Capital Cities Cable, Inc. v. Crisp*, 467 U.S. 691, 697-98 (1984).

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11. The problem of "interlocking" bankruptcies arises in a variety of contexts. Here the two bankrupts have mutual debts. The problem may also arise where two bankrupts are parties to an executory contract or unexpired lease, *see In re Hawaii Dimensions, Inc.*, 47 Bankr. 425 (D. Hawaii 1985), or where two bankrupts are parties to a guaranty and subordination agreement, *see In re Wyse*, 340 F.2d 719 (6th Cir. 1965). In any of these contexts, the protections afforded one bankrupt may conflict with protections afforded the other.

CJI's contention that orders entered in the Central Railroad bankruptcy bar setoff by Reading in its bankruptcy case has two variations. First, CJI contends that the setoff claim was laid to rest by final orders vesting Central Railroad's assets in CJI free and clear of encumbrances and is now precluded by the doctrine of *res judicata*. Second, it contends that the discharge of Central Railroad meant that, by the time Reading asserted its setoff, there was no longer a mutual debt to setoff. Both arguments ignore fundamental principles of bankruptcy jurisprudence.

"There is lacking in this case the first and most essential element of *res judicata*, namely, former judgment of a competent court, adjudicating the matter in controversy between the parties . . . ." *Cumberland Glass Manufacturing Co. v. DeWitt*, 237 U.S. 447, 458 (1915). Reading was enjoined by orders entered in the Central Railroad bankruptcy from setting off its claims against Central Railroad during the pendency of that proceeding; thus, the issue of setoff was not and could not have been adjudicated during the pendency of the Central Railroad proceeding. This alone is sufficient to defeat the plea of *res judicata*. There is, however, a more fundamental reason for rejecting CJI's argument. The doctrine of *res judicata* is designed to protect judgments from collateral attack in courts of *coordinate* jurisdiction. In the case of two bankruptcy courts, each having *exclusive* jurisdiction over the estate that is being reorganized or liquidated under its auspices, the mutual prebankruptcy claims of the debtors fall within a twilight zone of uncertainty — each court has the power to impair one or both claims, and each has a different set of interests to protect. *Cf. Isaacs v. Hobbs Tie & Timber Co.*, 282 U.S. 734, 739 (1931) ("The jurisdiction in bankruptcy is made exclusive in the interest of the due administration of the estate and the preservation of the rights of both secured and unsecured creditors.").

The question of when and how a bankruptcy court may act with respect to claims that may impinge upon prior

orders of another bankruptcy court is not one susceptible of a pat answer. Surely, the "first in time, first in right" rule implicit in CJI's *res judicata* argument is not the answer. Rather, "[i]n this area of the law, 'an ample degree of discretion, appropriate for disciplined and experienced judges, must be left to the lower courts.' " *Zambrana v. Califano*, 651 F.2d 842, 844 (2d Cir. 1981) (quoting *Kerotest Manufacturing Co. v. C-O-Two Fire Equipment Co.*, 342 U.S. 180, 183-84 (1952) (Frankfurter, J.)). Here, the district court, having all relevant considerations before it, exercised its discretion and allowed an offset that arguably upset CJI's expectations under orders issued by another district court.[12] As set forth above at page 10, the district court below properly balanced the equities, and its judgment should not have been disturbed.

The more prosaic variation of CJI's "prior adjudication" theory contends that because Central Railroad's debt to Reading was discharged upon consummation of its reorganization plan in 1979, there was no longer any mutual debt for Reading to set off in 1982 when CJI demanded its payment under Reading's reorganization plan. The district court rejected this argument, stating that "where a debtor brings an action on a pre-bankruptcy claim, a creditor can set off a discharged, pre-bankruptcy claim against the debtor. Thus, while discharge bars affirmative recovery, it does not bar the use of setoff as a defense to a pre-petition claim" (16a) (citations omitted).

The district court's holding is fully supported by logic and relevant authority. In *Cumberland Glass Manufactur-*

12. It is questionable just how reasonable those expectations were. There is always uncertainty as to how collectible a claim will prove to be, and that uncertainty is all the greater when the obligor has itself sought relief under the bankruptcy laws. Moreover, as set forth at page 10 *supra*, CJI was required under Central Railroad Order 965 to collect its claim against Reading by deducting it from the distribution of Series 1 Contingent Notes that Reading would otherwise have been entitled to receive. CJI chose not to do so.

ing Co. v. DeWitt, the majority of this Court reserved decision of this very question, holding that it was not properly raised. 237 U.S. at 458. The four dissenters, however, did reach the issue and concluded that setoff of a discharged debt was permissible. Their rationale, which has been echoed by nearly every court to subsequently address the issue,[13] was simply that a contrary rule would permit a debtor, prior to asserting claims it possessed, to strategically shed itself of offsetting counterclaims through bankruptcy proceedings. 237 U.S. at 459-468 (White, C.J., and Hughes, Lamar and McReynolds, JJ., dissenting). Such strategic use of the discharge as a sword, rather than a shield, is antithetical to the salutary purposes of the bankruptcy laws—relieving honest debtors from oppressive indebtedness and allowing creditors to share in available assets in a fair and orderly manner. This Court should now avail itself of the opportunity to announce that this perversion of the bankruptcy process will not be allowed.

13. *See Binnick v. Avco Financial Services*, 435 F. Supp. 359 (D. Neb. 1977); *In re Morgan*, 77 Bankr. 81 (Bankr. S.D. Miss. 1987); *In re Conti*, 50 Bankr. 142 (Bankr. E.D. Va. 1985); *In re Ford*, 35 Bankr. 277 (Bankr. N.D. Ga. 1983); *In re Slaw Construction Corp.*, 17 Bankr. 744 (Bankr. E.D. Pa. 1982). *But see In re Johnson*, 13 Bankr. 185 (Bankr. M.D. Tenn. 1981). It is noteworthy that this result has been reached even under the current Bankruptcy Code, despite its explicit statement, not found in the Bankruptcy Act, § 14(f)(2), that a discharge operates as an injunction against setoff of discharged debts. 11 U.S.C. § 524(a)(2) (1982).

CONCLUSION

For the foregoing reasons, Reading Company's Petition For A Writ of Certiorari should be granted.

Respectfully submitted,

William H. Ewing
(Counsel of Record)
Gary A. Rosen
HANGLEY CONNOLLY EPSTEIN
CHICCO FOXMAN & EWING
1429 Walnut Street, 14th Floor
Philadelphia, PA 19102
(215) 864-7720

Attorneys for Petitioners

Dated: April 27, 1988

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 87-1232

In the Matter of
READING COMPANY,

Debtor

CJI Industries, Inc., formerly
known as Central Jersey
Industries, Inc.,

Appellant

On Appeal From The United States District Court
For The Eastern District Of Pennsylvania
(Bankruptcy No. 71-0828)

Argued October 5, 1987

BEFORE: WEIS, and STAPLETON, *Circuit Judges*,
and COHILL, *District Judge**

(Opinion filed January 29, 1988)

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* Honorable Maurice B. Cohill, Jr., United States District Judge for the Western District of Pennsylvania, sitting by designation.

Howard H. Lewis (Argued)
Timothy I. McCann
Sprecher, Felix, Visco,
Hutchison & Young
23rd Floor Fidelity Building
123 South Broad Street
Philadelphia, PA 19109

Attorneys for Appellee

Stanley Weiss (Argued)
Carpenter, Bennett & Morrissey
Three Gateway Center
100 Mulberry Street
Newark, NJ 07102

Attorney for Appellant

OPINION OF THE COURT

STAPLETON, *Circuit Judge*:

This appeal requires us to consider the extent to which the presumption against setoffs in Section 77 railroad reorganizations, articulated in *Baker v. Gold Seal Liquors*, 417 U.S. 467 (1974), is applicable to cases brought under the Regional Rail Reorganization Act of 1973, 45 U.S.C. § 701 *et seq.* (1982 & Supp. IV) ("Rail Act"). The district court concluded that the presumption does apply, but that countervailing equitable considerations in this particular Rail Act reorganization rendered appropriate a setoff of obligations between the debtor and another reorganized railroad. We hold that the presumption against setoffs in reorganizations under Section 77 is applicable, and that the countervailing concerns in this case do not overcome the presumption. Accordingly, we will reverse.

I.

Both parties, appellant CJI Industries, Inc. (CJI) and appellee Reading Company (Reading), were reorganized pursuant to the Rail Act, 45 U.S.C. § 701 *et seq.*, after having conveyed their assets to Conrail. CJI emerged from reorganization proceedings involving the Central Railroad Company of New Jersey (CNJ), which filed for reorganization on March 23, 1967 and was finally reorganized on September 13, 1979. Reading entered reorganization on November 23, 1971, beginning a process which lasted nearly as long.

The interactions of the two companies relevant to this appeal date to early 1978, when Reading decided to accept, in exchange for its claims in the CNJ reorganization, the terms of a settlement designed to facilitate consolidation and satisfaction of Reading's and other railroads' outstanding interline claims against CNJ. The settlement, which CNJ entered into with the Committee of Interline Railroads, proposed a three part disposition of the claims of each railroad that agreed to it. The first part, comprising 35% of the claims, would be paid in cash. The second portion, 25%, would be treated as ordinary administration claims; the final 40% would be considered general, pre-reorganization unsecured debt.

Reading's unsecured claims were found to total $466,428.35. CNJ's reorganization plan proposed that these claims, and the claims of CNJ's other unsecured creditors, be tied to litigation pending against the United States government. The litigation, CNJ's Valuation Case, was a dispute concerning the value of the assets CNJ had transferred to Conrail in connection with the reorganization proceedings. According to CNJ's proposal, the proceeds realized from the Valuation Case would be placed in a trust, to be distributed to CNJ's creditors based on their

respective priorities. Reading's potential interest would be embodied in "Series I notes," which were to be inferior in priority to those of several other classes of creditors. Reading would receive compensation only after higher priority creditors had been paid in full.

The district court supervising CNJ's reorganization confirmed CNJ's plan. *See In the Central Railroad of New Jersey*, 473 F.Supp. 225 (D.N.J. 1979)(approving the plan after appeal to the Court of Appeals). Accordingly, Reading was given its Series I notes and CNJ's other creditors were provided for similarly, which left CNJ, as stated in Order 965:

> free and clear of all claims, rights, demands, interests, liens and encumbrances of every kind and character, whether or not properly or timely filed and whether or not approved, acknowledged or allowed in these proceedings.

App. at 93. The district court's orders suggested that Reading's sole remaining recourse was against the proceeds of Valuation Case.

Reading's own reorganization plan took effect on January 1, 1981. According to the plan, each unsecured creditor was entitled to an interest-bearing unsecured note covering its claim. CJI held claims against Reading totalling $497,945.52. When CJI attempted to obtain a note in the amount it was owed, Reading raised the issue of setoff for the first time. Reading argued that it was entitled to set off the notes it had received in the CNJ reorganization, whose face value, as noted above, was $466,428.35, against CJI's $497,942.52 unsecured claim. CJI objected to this strategic use of the Series I notes.

Reading and CJI met several times in early 1981 in an effort to resolve their differences. At one point, senior officers of the two companies had reached a tentative agreement with respect to their claims

against one another. Reading's Board of Directors forwarded the agreement to the Reading Executive Committee, which apparently gave one of Reading's directors, Joe Castle, informal notice that the committee approved the proposal. Reading's Executive Committee failed to take further action, however, and a letter and copy of the agreement sent by Reading to CJI's president, Robert Timpany, were not responded to. The negotiations were not further pursued.

Subsequently dissatisfied with the state of affairs, CJI petitioned the district court for an order directing Reading to issue unsecured notes for the entire $497,945.52 owed it by Reading. The court held a hearing to consider CJI's petition. CJI's position at the hearing was that the Supreme Court's decision in *Baker v. Gold Seal Liquors*, 417 U.S. 467 (1974), precluded Reading from effecting a setoff. CJI argued that:

> it is fairly clear, after the Supreme Court ruled in *Baker* and from Justice Stewart's concurring opinion in terms of his understanding of what they were saying, that setoffs are just not acceptable in a 77 context.

App. at 171-172. Reading sought to distinguish *Baker* and to demonstrate that Reading's reorganization, by its terms, mandated setoff.

The district court agreed with Reading. While conceding that *Baker* generally disapproves setoffs in railroad reorganizations under Section 77 of the Bankruptcy Act, 11 U.S.C. § 205 *et seq.* (1970), the court concluded that *Baker* did not establish an absolute prohibition of setoffs. App. at 196. The court deemed it necessary to conduct an inquiry into equitable considerations. It noted the fact that neither Reading nor CJI existed any longer as functioning railroads, and expressed the view that it would be

unfair if CJI were permitted to preserve its full unsecured claim in the Reading reorganization, which promised a possible 100% return, while Reading was left saddled with $466,428.35 in CJI notes of indeterminate value. The court ultimately concluded that Reading's $466,428.35 should cancel a like portion of CJI's unsecured claim, and that Reading need only issue unsecured notes for the remaining $31,517.17.

On appeal, CJI argues that the district court misapplied *Baker*. CJI contends that *Baker* prohibits setoff under any circumstances. Alternatively, CJI insists that even if setoff still may be appropriate in extraordinary circumstances, the district court abused its discretion by allowing setoff in this case. We agree with the latter contention. In light of the authorization found in § 601(b)(4) of the Rail Act, 45 U.S.C. § 791(b)(4), for a reorganization under the Rail Act to proceed as if it were a reorganization under Section 77, we conclude that *Baker* is controlling in this context, and that the Supreme Court's decision requires us to prohibit setoff in this case.[1]

II.

The Supreme Court's decision in *Baker v. Gold Seal Liquors*, 417 U.S. 467 (1974), made clear that setoffs are generally not allowed in railroad reorganizations. *Baker* involved an appeal from a

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1. Our holding makes it unnecessary to address several arguments advanced by CJI as alternatives to reliance on *Baker*, such as CJI's contention that mutuality of debts, a prerequisite to setoff, did not exist because CJI was in reality no longer indebted to Reading; nor need we determine the validity of CJI's contention that the orders of its reorganization court constitute final judgments that preclude, through res judicata, Reading's subsequent assertion of setoff rights in the Reading reorganization.

district court's decision to allow a setoff requested by a shipper seeking to offset cargo loss and damage claims against freight charges claimed by a railroad's trustees. After the Court of Appeals affirmed the district court's ruling, the Supreme Court reversed. The Court described the procedure in ordinary bankruptcy cases, where setoff is routinely allowed[2] and arguably may be compulsory in some instances.[3] The Court concluded, however, that Section 77 cases must be viewed differently, because reorganization is the focus of Section 77, whereas ordinary bankruptcy cases typically result in liquidation.[4] The court noted that the emphasis on reorganization in Section 77:

> entails two basic considerations. First, is the collection of amounts owed the bankrupt to keep its cash inflow sufficient for operating purposes . . . The second is to design a plan . . . which will meet the fair-and-equitable standards required by the Act for Court approval.

417 U.S. at 470-471.

With respect to the second concern, the Court pointed out that the:

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2. *See Baker*, 417 U.S. at 469. Section 68 of the old Act, 11 U.S.C. § 108, now found (as amended) in § 553, explicitly provided for setoffs.

3. F.R.C.P. Rule 13(a) may require setoff where the potential setoff arises from a cause of action related to a claim raised by the party against which the setoff would be effected.

4. *See, e.g.*, 5 *Collier on Bankruptcy* ¶ 77.10 (14th ed. 1978). *Collier* suggests that although § 77(l) describes ordinary bankruptcy provisions as generally applicable to Section 77 cases, these provisions are not always appropriate because "Chapter VIII as a whole is such a wide departure from the usual bankruptcy law and practice, and the purpose of the section is conservation and rehabiliation rather than liquidation." *Id.*

> guiding principle governing priorities is stated in § 77e(l), 11 U.S.C. § 205(e)(1): the Reorganization Court shall approve a plan if it "is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders."

417 U.S. at 473. Setoffs were seen by the Court as conflicting with this principle because they afford affected creditors different treatment than that received by creditors, otherwise similarly situated, who have no offsetting claim on which to base a setoff.[5] In the *Baker* situation, for example, the Court noted that the setoff permitted by the Reorganization Court "grants a preference to the claim of one [unsecured creditor] over the others by the happenstance that is owes freight charges that the others do not." 417 U.S. at 474. This, the Court concluded, "is a form of discrimination to which the policy of § 77 is opposed." The Court held that "[a]s a general rule of administration for § 77 Reorganization Courts, the setoff should not be allowed." 417 U.S. at 474. The Court's holding has been read as establishing a strong anti-setoff policy. *See, e.g., Matter of Penn Central Transportation Co.*, 458 F.Supp. 1234, 1330 (E.D. Pa. 1978)(setoff not appropriate in Section 77 cases except perhaps in truly extraordinary circumstances such as lender fraud).

Reading attempts to distinguish the circumstances under which *Baker* was decided from

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5. While ordinary unsecured creditors are likely to receive only a fraction of their claims' face values, an unsecured creditor who is allowed a setoff may receive what is in effect full payment, because he or she, through setoff, cancels debts owed the debtor.

those of the present case. Reading points out that, while *Baker* arose in the context of an ordinary Section 77 reorganization, both Reading and CJI have reorganized pursuant to the Rail Act, which governs reorganization of railroads that have conveyed their assets to Conrail. Section 77 proceedings usually result in a reorganized, ongoing railroad. Rail Act reorganizations, on the other hand, often reorganize companies that, having sold their operating assets to Conrail, no longer consist of ongoing businesses.[6] Thus, Rail Act reorganizations arguably constitute a unique form of railroad reorganization. Reading would have us conclude from this that *Baker*, because it arose under Section 77 rather than the Rail Act, is of no moment in Rail Act contexts.

While *Baker* does attach significance to the focus on reorganization in Section 77, we cannot accept Reading's argument that the absence of an ongoing underlying business renders *Baker* inapplicable. Section 601(b)(4) of the Rail Act, 45 U.S.C. § 791(b)(4), expressly directs that the reorganization court:

> shall proceed to *reorganize or liquidate [the] railroad in reorganization pursuant to . . . Section 77 on such terms as the court deems just and reasonable*, or pursuant to any other provisions of the Bankruptcy Act . . . (emphasis supplied).

Section 601(b)(4) makes clear that Section 77, and caselaw decided under that section, continues to apply in the context of a Rail Act proceeding, despite the absence of an ongoing business. As we pointed out in *Matter of Lehigh Valley Railroad Co.*, 558 F.2d 137

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6. What remains following the asset sale is a skeleton company consisting primarily of proceeds from the sale. The company is essentially a trust holding funds belonging to its creditors, and its "reorganization" effects a liquidation.

(3d Cir. 1977), "'[Section] 77 . . . continues in effect except where specifically contradicted by the Rail Act.'" 558 F.2d at 141, quoting Blatchly, *Railroad Reorganization Under the Regional Rail Reorganization Act of 1973: An Overview*, 40 Albany L. Rev. 812, 828 (1976). *See also Matter of Central Railroad Co. of New Jersey*, 425 F.Supp. 1055, 1058 (D. N.J. 1976)("[The Rail Act] supplements but does not displace Section 77."); 5 *Collier on Bankruptcy* ¶ 77.01[5] (14th ed. 1978).

In adopting the Rail Act, and § 601(b)(4) in particular, Congress was cognizant that Railroad Act cases would involve the reorganization of railroads no longer maintaining an ongoing business. *See Matter of Lehigh Valley Railroad Co.*, 558 F.2d 137, 142 (3d Cir. 1977)("Congress must have been aware, when it enacted [§ 601(b)(4)], that none of the railroad estates would actually be operating trains any longer."). Section 601(b)(4) suggests that, although Congress was mindful of the relevance of railroads' cessation of operations, it concluded that the railroads still should be permitted to reorganize as if they were ongoing railroads. *See also Lehigh Valley*, 558 F.2d at 146 (The case law provides "persuasive support for the proposition that the reorganization of a railroad may properly continue under Section 77 despite the fact that the enterprise is no longer capable of being reorganized into a working railroad."). To adopt Reading's suggestion that the absence of an ongoing business by itself renders *Baker* inapplicable would be to ignore Congress's clear intention that Rail Act cases be treated as Section 77 cases are. We decline to take this step.

Reading also argues that *Baker*, even if applicable, does not preclude setoff in all cases. Reading relies for this proposition upon a footnote to the final sentence of the *Baker* decision. The footnote asserts that:

> *Lowden v. Northwestern National Bank & Trust Co.*, 298 U.S. 160, is not to the contrary. . . . The preference sought here shows no exceptional circumstances which in equity justify the discrimination.

417 U.S. at 474 & n.13. *Lowden* involved the same issue as *Baker*, whether setoff is appropriate in Section 77 proceedings. The Supreme Court, while declining to reach the issue because the questions that had been certified were worded too abstractly, did suggest that courts should address the setoff question on a case-by-case basis. *See* 298 U.S. at 166. Because the *Baker* opinion asserts explicitly that it is consistent with *Lowden*, Reading insists, *Baker* too invites an inquiry into equitable considerations.

CJI urges us to reject this reasoning and argues that the presumption against setoffs announced in *Baker* amounts to an absolute prohibition. Although the Court's holding in *Baker* is strongly worded and, particularly when contrasted with the concurrence, suggests broad applicability, we decline the invitation to so hold in this case. Where there is evidence suggesting that a creditor's circumstances are fundamentally different from those of the other creditors in its class, setoff may well be appropriate. *See, e.g., Matter of Penn Central Transportation Co.*, 458 F.Supp. 1234, 1330 (E.D. Pa. 1978) (Suggesting that a debtor's failure to invoke prebankruptcy setoff rights due to fraudulent representations made by the debtor might qualify as a circumstance exceptional enough to warrant post-petition setoff). On the facts of this case, however, we need not determine *Baker*'s precise scope.

It is enough to find that Reading simply has not demonstrated the existence of equitable considerations compelling enough to necessitate further inquiry. Reading's arguments in support of

setoff distill to two, the absence of an ongoing company to be reorganized and the fact that a debtor rather than an unsecured creditor sought the setoff. As discussed above, § 601(b)(4) undercuts Reading's contention that Section 77 guidelines are inappropriate solely because the Reading and CNJ reorganizations do not involve ongoing railroads.

Reading's suggestion that the applicability of the presumption against setoffs varies depending on which party invokes it is no more persuasive. Nowhere in the *Baker* opinion is there evidence that the Court contemplated a distinction based upon which party requested setoff. Moreover, the Supreme Court's concern in *Baker* that setoff would violate the fair and equitable requirement, 417 U.S. at 473-4, is fully applicable here. To permit Reading to effect a setoff would be to treat CJI less favorably than Reading's other unsecured creditors. Whereas the other creditors would receive unsecured notes likely to be paid in full, CJI's claim would be largely eliminated by Series I notes of indeterminate value. *Baker* specifically disapproved fortuitous discrimination between creditors of the same class and we see no administrative or other advantage significant enough to justify our sanctioning such discrimination. Accordingly, we conclude, as *Baker* suggests we must, that Reading should not be permitted to reduce its obligation to CNJ through setoff.

Reading also argues that Reading Reorganization Court Order 2004 mandates setoff. Order 2004 provides, in part, that:

> [A]ny such . . . creditor against whom the Debtor has a pre-bankruptcy claim which has not . . . been satisfied . . . shall pay such claim[] in cash.

App. at 75. On its face, this language does not appear to address the question of setoff. If anything, the order,

by requiring satisfaction in cash of the debtor's claims against its creditors, appears to preclude setoff. We need not engage in conjecture as to the order's intended effect, however. Even if it were a provision for setoff, as Reading argues, Order 2004 would clearly be inconsistent with *Baker*, and could not be effectuated. Thus, it cannot under any interpretation provide support for Reading's position.

III.

For the foregoing reasons, the order of the district court will be reversed and the case will be remanded for further proceedings consistent with this opinion.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

IN THE
United States District Court
FOR THE
Eastern District of Pennsylvania

In the Matter of	:	In Proceedings for the Reorganization of a
READING COMPANY	:	Railroad
Debtor	:	Bky. 71-828

MEMORANDUM AND ORDER

DITTER, J. March 31, 1987

Reading Company and Central Railroad Company of New Jersey ("CNJ") were both reorganized pursuant to section 77 of the Bankruptcy Act (formerly 11 U.S.C. § 205). Each debtor railroad possessed a pre-bankruptcy unsecured claim against the other: Reading's claim was for $466,428.35 while CNJ's claim was for $497,945.52. Central Jersey Industries, the reorganized CNJ, now petitions this court to direct Reading to issue unsecured creditor notes in the full amount of its claim. Reading claims that CJI is entitled only to $31,517.17, the net of CNJ's claim over Reading's claim. For the reasons that follow, CJI's petition will be denied.

By the terms of CNJ's plan of reorganization, unsecured claims were to be satisfied by the issuance of series I, nonrecourse notes payable from rail proceeds after payment of CNJ's senior obligations. *See also* CNJ order 965 (claims of creditors "will be satisfied pursuant to the plan"). CNJ's plan was confirmed by its reorganization court on August 5, 1979. Subsequently, CJI tendered the series I notes to Reading; however, Reading refused to accept them. Reading claims the series I notes are worthless since they are nonrecourse and the available proceeds are insufficient for their redemption. Reading, on the other hand, expects to pay its unsecured notes in full.

Order 2004 of this court, dated December 23, 1980, authorized consummation of Reading's amended plan of reorganization. The plan authorized the issuance of unsecured, recourse obligations, payable no later than April 1, 1988, in satisfaction of Reading's pre-bankruptcy, unsecured claims. These notes were to be issued on the consummation date except that:

> any such holder of securities, claimant or creditor against whom the Debtor has a pre-bankruptcy claim which has not, contrary to prior orders of this Court prohibiting setoffs, been satisfied or against whom any of the Reading Trustees has an unpaid post-bankruptcy claim which has been liquidated shall pay such claims in cash and shall be entitled to receive a distribution of securities or cash pursuant to the Plan only at such time as such claim of the Debtor or Reading Trustees is fully satisfied by payment of cash to the Reorganized Company or by deduction of the amount of such claim from any cash to which such holder of securities, claimant or creditor would otherwise be entitled to receive pursuant to the Plan.

Order 2004, § 4.03(d)(i).[1]

CJI contends that Reading's debt was discharged and satisfied pursuant to CNJ's plan; therefore, it was entitled to receive Reading's unsecured notes in the full amount of its claim on the consummation date. Reading asserts CNJ is not entitled to receive its unsecured notes because CNJ did not pay Reading's claim in cash as Order 2004 provides. In the alternative, Reading asserts a right to an equitable setoff of its pre-bankruptcy claim against CNJ's pre-bankruptcy claim. For the reasons that follow, Reading is entitled to an equitable setoff. Consequently, it is unnecessary to decide whether CNJ is entitled to payment by the terms of Reading's plan.

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1. CNJ order 965, issued in aid of implementation of CNJ's plan, contained identical language. Nevertheless, CNJ tendered its notes to Reading prior to satisfaction of its pre-bankruptcy claim.

In bankruptcy, a creditor is entitled to setoff mutual debts that arose prior to commencement of the case. 11 U.S.C. § 553 (formerly section 68 of the Bankruptcy Act). The debtor and the trustee also possess the right to setoff. *In re Braniff Airways, Inc.*, 42 Bankr. 443 (Bankr. N.D. Texas 1984); 4 W. Collier on Bankruptcy ¶553.12 (15th ed. 1986); 4 W. Collier on Bankruptcy § 68, at 946 (14th ed. 1978). Even though setoff affords one creditor a preference over other creditors, it is permitted and favored because of the injustice that results if one creditor must pay full value while forfeiting his own claim. *Bohack Corp. v. Borden, Inc.*, 599 F.2d 1160 (2d Cir. 1979); *Krajci v. Mt. Vernon Consumer Discount Co.*, 16 Bankr. 464 (E.D. Pa. 1981).

It is also clear that where a debtor brings an action on a pre-bankruptcy claim, a creditor can offset a discharged, pre-bankruptcy claim against the debtor. *Krajci, surpa; In re Shaw Construction Corp.*, 17 Bankr. 744 (Bankr. E.D. Pa. 1982). Thus, while discharge bars affirmative recovery, it does not bar the use of setoff as a defense to a pre-petition claim. Hence, even if Reading's pre-petition claim was discharged by CNJ's plan, Reading would not be precluded from raising it as a defense to CJI's affirmative action on its pre-bankruptcy claim.

With these principles in mind, the decisive issue is whether an equitable setoff is appropriate at this juncture of a section 77 reorganization. Former section 68 was not directly applicable to a section 77 reorganization. CJI contends that, as a rule, setoffs are not permitted in a section 77 reorganization. In the alternative CJI urges that the equities weigh in favor of rejecting Reading's claimed setoff.

CNJ principally relies on *Baker v. Gold Seal Liquors, Inc.*, 417 U.S. 467 (1974), where the Supreme Court stated, "[a]s a general rule of administration for § 77 Reorganization Courts, the setoff should not be allowed." In reaching its decision, the Supreme Court, emphasizing the peculiar need in reorganization to continue the debtor as a going concern, focused on two major responsibilities facing a reor-

ganization court: 1) the preservation of cash inflow during the pendency of reorganization sufficient to maintain operations at a survival level; and 2) the formulation of a "fair and equitable" plan, satisfactory to creditors, that preserves an ongoing railroad. The setoff sought in *Baker* was inconsistent with the goal of preserving cash inflow. The Court further found that the allowance of a preference to one creditor over another by a setoff is a form of discrimination at variance with the policy of section 77.

In a footnote, the Court in *Baker* stated that its decision was not contrary to *Lowden v. Northwestern National Bank & Trust Co.*, 298 U.S. 160 (1936), because no exceptional circumstances were shown which, in equity, would justify discrimination against other creditors. In *Lowden*, the Supreme Court stated that during the pendency of reorganization proceedings, setoffs are governed by balancing the equities which vary with each case. *See also Baker*, 417 U.S. at 476 (Stewart, J., concurring) (favoring a case by case analysis in light of equitable considerations).

The *Baker* decision, while clearly disfavoring the use of setoffs by creditors in section 77 reorganizations, does not create an absolute bar to setoffs. Moreover, the present case is distinguishable from *Baker*. The lower court in *Baker* permitted a setoff and *positive* judgment against the debtor, Penn Central, during the pendency of reorganization when preservation of cash inflow is essential to reorganization. In addition, the Penn Central reorganization court had enjoined secured creditors from selling the collateral or "offsetting the same, or any [sic] thereof, against any obligation of the Debtor, until further order of this Court." *Baker*, 417 U.S. at 472 n.8 (quoting order of the reorganization court). Here, the plans of CNJ and Reading are consummated; therefore, the preservation of cash inflow is not a consideration. Moreover, CJI has not presented evidence that its reorganization court currently enjoins setoffs as was the situation in *Baker*. Finally, this action was instituted in Reading's reorganization court and the debtor is asserting

the right to setoff. Thus, it is appropriate to consider Reading's attempted setoff in light of equitable considerations.

CJI contends that equitable considerations warrant disallowance of the claimed setoff because it would not be "fair and equitable" to CNJ's creditors. CJI reasons that a setoff would give Reading a preference over other creditors in contravention of *Baker*. Moreover, CJI claims a setoff would be unfair because CNJ's creditors approved the plan in reliance upon the availability of the claim against Reading as an asset of CNJ.

The CJI argument fails to consider the full implications of its petition in Reading's reorganization. This court must not only consider what is "fair and equitable" to CNJ's creditors but also what is "fair and equitable" to Reading's creditors. Thus, CJI's blanket reliance on *Baker's* disavowance of preferences is misplaced.

Setoffs are favored in bankruptcy because their use prevents one creditor from paying a debt while forfeiting a comparable claim. Where the right to setoffs is asserted with respect to claims between two reorganized companies following reorganization, this concern is especially acute.

Reading's creditors considered Reading's claim against CNJ to be an asset available for distribution as did CNJ's creditors with respect to CNJ's claim. It is undisputed, however, that CNJ's series I notes are worthless. Clearly, it would not be "fair and equitable" to Reading's creditors for Reading to pay full value on a debt while at the same time forfeiting a comparable claim. Thus, to deny Reading's right to setoff would discriminate in favor of CNJ and its creditors against Reading and its creditors.

Moreover, CJI's assertion that CNJ creditors relied on full payment by Reading in approving CNJ's plan is questionable. CNJ's claim against Reading was an unsecured debt that was, until consummation of Reading's plan, subject to the same risks regarding payment as were CNJ's unsecured debts. Thus, it was conceivable that Reading would pay its unsecured creditors with worthless, nonrecourse notes.

In addition, permitting Reading's setoff is equitable since Reading and CJI would have had to setoff their claims if CJI had adhered to its plan and order 965.

Under both reorganizations, a creditor who owed a pre-bankruptcy claim to the debtor railroad would not receive payment after consummation until he paid his debt to the railroad. Thus, CJI was not authorized by the CNJ plan to tender its series I notes to Reading since Reading's pre-bankruptcy debt to CNJ was still outstanding. Similarly, until CNJ paid its debt to Reading, Reading would not have been authorized under its plan to tender its unsecured notes to CNJ. In such an impasse, the railroads would have to offset their claims against each other or there would be a stalemate forevermore. The only difference now is that CJI prematurely tendered its notes to Reading. This circumstance does not warrant a decision that Reading must pay its debt in full while receiving nothing for its claim. Clearly, setoff of Reading and CNJ's pre-bankruptcy claims is appropriate.

An order follows.

IN THE
United States District Court
FOR THE
Eastern District of Pennsylvania

In the Matter of	:	In Proceedings for the Reorganization of a
READING COMPANY	:	Railroad
Debtor	:	Bky. 71-828

ORDER

AND NOW, this 31st day of March, 1987, the petition of Central Jersey Industries, Inc., to compel payment of its pre-bankruptcy claim against Reading Company is hereby denied for the reasons set forth in the accompanying memorandum.

It is further ordered that within twenty days from the date of this order, Reading shall issue to CNJ unsecured creditor notes in the amount of $31,517.17.

By the Court:

/s/ J. WILLIAM DITTER, JR.

J.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 87-1232

In the matter of
READING COMPANY,
Debtor

CJI Industries, Inc.,
formerly known as
Central Jersey Industries, Inc.,
Appellant

(Bankruptcy No. 71-0828)

ON APPEAL FROM THE
United States District Court
FOR THE
Eastern District of Pennsylvania

Present: WEIS, and STAPLETON, *Circuit Judges*, and COHILL, *District Judge**

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel October 5, 1987.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, entered April 1, 1987, be, and the same is hereby reversed and the cause remanded to the said District Court for further proceedings consistent with the opinion of this Court. Costs taxed against the appellee.

ATTEST:

/s/ SALLY MRVOS

Clerk

January 29, 1988

*Hon. Maurice B. Cohill, Jr., U. S. District Judge for the Western District of Pennsylvania, sitting by designation.